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## THE ECONOMIC AND POLITICAL CONSEQUENCES OF INDIA'S FINANCIAL PROBLEMS

*Submitted by the*

### DIRECTOR OF CENTRAL INTELLIGENCE

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# THE ECONOMIC AND POLITICAL CONSEQUENCES OF INDIA'S FINANCIAL PROBLEMS<sup>1</sup>

## THE PROBLEM

To estimate probable economic and political consequences of India's financial problems.

## SUMMARY AND CONCLUSIONS

1. India, midway through its Second Five Year Plan (1956-61), has encountered increasingly serious economic difficulties during the past year. Pledges at the end of August 1958 of \$600 million in new aid (including \$350 million for the current year) by the US, other Western countries, and the International Bank for Reconstruction and Development are expected to cover India's immediate needs and to reduce its foreign exchange gap for the remaining period of the reduced Plan to about \$400 million. This estimate of the gap excludes the cost of the bulk of the very substantial food import requirements which the Indians hope to obtain under the PL-480 program. (*Paras. 4-10*)

2. Nevertheless, India will continue to depend heavily on foreign assistance. If it fails to obtain the aid still needed to close the foreign exchange gap, it will probably fail to achieve even the present reduced goals of the Plan. The recent trend to-

ward a weakening of the Congress Party and toward an increase in Communist strength would almost certainly be intensified. If, on the other hand, India gets a substantial part of the additional foreign exchange it needs, important economic progress will be made and the prospects for maintaining an effective parliamentary system under moderate leadership will be strengthened. Even in this case, however, the country would still be a long way from solving its principal economic difficulties, unemployment and food, or its basic political and social problems. (*Paras. 16-25*)

3. India is so thoroughly committed to a policy of neutralism that any significant change in foreign policy during the next few years is most unlikely regardless of whether India gets the aid it needs from the West, from the Soviet Bloc, or not at all. However, the political and economic instability which would follow a breakdown in the development program would result in India's becoming increasingly vulnerable to extremist, and especially Communist, influences. (*Paras. 28-30*)

<sup>1</sup> Supersedes NIE 51-57: "Consequences of Economic Crisis in India," dated 8 October 1957.

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## DISCUSSION

## I. THE ECONOMIC PROBLEM

4. The economic problems facing India, which is now mid-way through its Second Five Year Plan (1956-61), have intensified greatly during the past year. Drought conditions resulted in a sizeable reduction in food production in 1957-58; prospects for the 1958-59 crop are no better than average. During the remainder of the Plan period, India will probably have to import at least twice as much food as originally forecast. Prices, which appeared to have stabilized last year, are moving slowly upward again — chiefly as a result of fear of a possible food shortage, although heavy deficit financing has also contributed to the price rise.

5. The rate of increase of industrial production for 1957-58 was lower than in recent years, reflecting in part scattered shortages of imported raw materials. Nevertheless, total imports have risen sharply, mainly as a result of increased purchases of food and defense equipment as well as of capital goods. Exports have declined somewhat and probably will rise only slowly for the remaining period of the Second Plan. Foreign exchange reserves have already declined about three times more than was anticipated for the entire Plan period, and they are nearing the danger point.

6. The foreign exchange shortage has adversely affected not only the Second Five Year Plan but the whole Indian economy. Imports for the Plan are only a small part of the total imports required to keep the economy operating at or near capacity. The government has already curtailed imports of raw materials and semi-finished goods to the point where some factories have reduced production, and others are maintaining production only by living off stocks. Consumer goods imports — excluding foodstuffs — have also been sharply curtailed.

7. The Second Five Year Plan has been cut back to adjust to these unfavorable developments. The reductions have been primarily in the field of social services. In 1957, the expenditure target for the public sector of the

Plan was revised downward from the equivalent of \$11.5 billion to \$10.1 billion. It has now been in effect reduced to \$9.5 billion, of which about \$2.2 billion must be provided by foreign aid. Actual outlay will probably not exceed \$9.0 billion. This would reduce total cost of the public sector of the Plan and probably physical achievement by about one-fifth. The private sector, for which an expenditure of \$5.0 billion was originally scheduled, is likely to achieve only about three-fourths of the targets set for it in the Plan, principally because of inadequate foreign exchange.

8. Despite the latest reduction in the Plan, the total uncovered balance-of-payments deficit on current account for the Second Plan period appeared to be considerably greater than was anticipated a year ago. At that time an uncovered deficit of \$1.4 billion was estimated for the remaining 3½ years of the Plan. In the spring of 1958, however, Indian officials estimated that, despite additional foreign aid of about \$500 million, the deficit for the final three years (April 1958-March 1961) would still be \$1.3 billion.<sup>2</sup> Principal

<sup>2</sup> Table I.

TABLE I

Estimate of India's Balance of Payments  
April 1958-March 1961  
(as of June 1958)  
(in billions of US dollars)

I. Current Account		
Imports	-6.8 *	
Exports	+4.0	
Trade Balance		-2.8
Invisibles (net)		+0.5
Balance		-2.3
II. Capital Account		
Foreign grants and loans (committed but unexpended)		+0.9
Other		+0.1
		+1.0
III. Uncovered deficit		-1.3 *

\* Excludes PL-480 program.

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reasons for the increase were a lower — and more realistic — estimate of export earnings, rising prices of imported capital goods, and higher defense expenditures. This estimate of the deficit excluded the cost of the bulk of anticipated food imports, which the Indians assume they will obtain under the PL-480 program. The new estimate of the deficit appears to have been reasonable, although events may require some revision.

9. Assuming that its gold and foreign exchange reserves are permitted to fall to \$500 million, India will be able to finance approximately \$300 million of the deficit out of its reserves. To run the reserves down much below \$500 million would risk undermining confidence in the currency and would probably bring about some capital flight. At the present rate of drawdown, reserves will reach \$500 million by the end of this calendar year. Assuming such a use of reserves, the

uncovered foreign exchange gap to be filled by external sources during the remaining period of the present Plan was estimated at approximately \$1.0 billion. The most critical aspect of India's financial problem was that \$300-350 million of the \$1.0 billion was required during the present Indian fiscal year, ending 31 March 1959.

10. In a meeting sponsored by the IBRD in Washington 25-27 August 1958, Canada, West Germany, Japan, the UK, the US, and the IBRD indicated their intention to provide India with approximately \$350 million in new aid before the end of the present Indian fiscal year. In addition, various of the participants expressed their intention to make available another \$250 million in aid during the final two years of the Plan period. Thus, India's foreign exchange gap for the remainder of the Plan period has been reduced to an estimated \$400 million. (See Table II.)

TABLE II

New Aid Pledged to India  
(IBRD meeting, 25-27 August 1958)  
(in millions of dollars)

	<u>Available by March 1959</u>	<u>Additional for April 1959-March 1961</u>	<u>Remarks</u>
Canada	17	28	Grants under Colombo Plan
W. Germany	40	60	Loans (4 and 10-12 years)
Japan	10	—	Line of Credit
United Kingdom	108	—	Loans (5 to 20 years)
United States *	75	app. 25 **	DLF long-term loans repayable in rupees tied to projects but not necessarily new projects
	3.5	14	Deferment of loan payments
IBRD	100	125	Long-term loans, including \$25 million already announced
	<u>353.5</u>	<u>252</u>	

\* The US also expects to be able in the near future to extend new assistance under PL-480 in an initial amount of about \$200 million.

\*\* Unexpended balance of \$100 million DLF loans to be extended in US FY 1959.

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## II. IMPACT OF MILITARY SPENDING

11. India's foreign exchange problem is aggravated by imports of military equipment. Indian officials have indicated that about \$200 million in foreign exchange was spent for military purposes in FY 1957-1958 and that something under \$400 million is projected for the last three years of the Plan period. About half of the latter amount will probably fall due in the present fiscal year. According to Indian officials, over \$200 million of this \$400 million is for deliveries contracted for prior to 1 April 1958, including British and French jet aircraft and a British aircraft carrier which is scheduled for delivery in 1960. We believe the estimated remaining balance of under \$200 million for normal upkeep and operating expenses of the military establishment which must be made abroad during the final three years of the Plan period may be inadequate.

12. Apart from the foreign exchange problem, the Indian military program is a major claimant for internal resources. The defense budget rose to \$640 million in FY 1958-59, i.e., about 35 percent of the ordinary budget or 18 percent of the central government's total budgetary expenditures, including outlays for development. While India may pare a certain amount from its planned military expenditures during the remainder of the Plan period, it is very unlikely, barring a major change in relations with Pakistan, to reduce them sufficiently to bring any significant relief in financing the Plan. In fact, India might further step up its military expenditures if it believed that Pakistan was increasing its military buildup or becoming more belligerent, even though India's present military establishment of about 450,000 men is more than twice as large as that of Pakistan.

## III. PROSPECTS FOR AID

13. While previously the emphasis was on the need for aid to cover new development projects, the problem as more recently recognized has been to obtain foreign exchange to finance projects already begun under the Plan and to cover the cost of other imports required for the current operation of the economy. India has also recognized the need, in seeking new cred-

its, to avoid insofar as possible an aggravation of the very heavy debt servicing burden which it already faces for the years immediately following the present Plan period. These considerations were reflected in the type and terms of the \$600 million new aid just pledged to India. (See paragraph 7.)

14. India appears almost certain to obtain from Western sources at least some of the remaining \$400 million it will need during the last two years of the Plan period. At the IBRD conference, the UK undertook in principle to continue its support of India beyond the current fiscal year. The other participants also expressed continuing interest in India's long-term financial problems.

15. India has already accepted about \$325 million in long-term project loans from the USSR and some of its European satellites. It is probably prepared to accept such further Bloc aid as it feels would be useful to the development program, particularly if its remaining foreign exchange gap is not closed by Western aid. However, additional aid for complete projects of the type already granted to India by the Bloc is not what India needs to meet its financial problem during the remainder of the Plan period. We consider it unlikely that the Bloc would extend substantial credits in gold or convertible foreign exchange. It might, however, be prepared to supply some additional aid for projects now underway or to take some of the pressure off the Indian foreign exchange squeeze by supplying imports of currently needed commodities, such as petroleum and steel, on favorable credit terms.

## IV. ECONOMIC OUTLOOK

16. The prospects, not only for the Second Five Year Plan but for the entire Indian economy, still depend heavily on the extent to which India is able to get the foreign exchange needed to fill the remaining gap. If, as now appears unlikely, India has little or no success in obtaining additional aid, some further cuts would probably have to be made in the development program. Raw material imports would have to be further reduced in the last two years of the Plan period. A rise in unem-

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ployment, a decline in the value of the rupee and a flight of capital, and general curtailment of investment would probably follow. While substantial progress on development projects has already been made and more is assured, the momentum gathered by the economy would be reduced and the Plan would probably fail to achieve even its present goals.

17. On the other hand, if India obtains all or nearly all of the foreign exchange required to close the gap, important, though moderate, economic progress would be achieved. Gross national product would probably increase about 20%, and per capita income about 10%, during the period of the present Plan. The newly completed factories would probably reduce many present import requirements, and practically eliminate steel imports, which are running at over \$300 million a year. The basis would be laid for continuing the process of modernizing the economy and for bringing India somewhat closer to the point where growth would be self-sustaining.

18. Even so, the country would still be a long way from solving its two principal economic problems: the provision of adequate employment and food for its people. A solution of these problems, if it is ever to be achieved, would require a development effort extending over many years. The present reduced Plan is expected to create an estimated 6.5 million jobs outside agriculture, but this figure is 1.5 million below the expected growth of the urban labor force during the same period. It appears likely that India will continue to require substantial food imports even at the end of the Second Plan period. India's foreign reserve position will remain precarious, and it will find it difficult to service the heavy foreign debts already incurred as well as to finance a Third Five Year Plan. An attempt will probably be made to delay repayment of some obligations. All of these factors have already caused Indian leaders to declare that the Third Plan will place increased emphasis on agriculture and small industries which require less imported equipment for expansion.

19. Although India's flexibility in the allocation of its foreign assets is limited by the fact that many projects have been financed by

loans which cannot be used for other purposes, it will gain some maneuverability as a result of the \$600 million in new aid pledged recently. Even in the present Plan there probably are still a few projects which could be stretched out without major repercussions. If sufficient additional foreign aid to close the gap is not forthcoming, the government may feel compelled in the final stages of the Plan to cut back more deeply on imports of raw materials and semi-finished goods — even at the immediate cost of declining production and rising unemployment — in order to complete major projects.

## V. POLITICAL OUTLOOK

20. *Nehru and the Congress Party.* Prospects for political stability in India depend to a large degree on progressive economic development. Nehru and the Congress Party have identified themselves closely with the development program, and their political fortunes will be affected by the outcome of the Second Five Year Plan. Popular interest in and approval of the development program are reflected in the general support given it by the opposition parties. The Communists, however, have accused the government of inefficiency in executing the Plan and have attacked the reduction of the Plan's original targets.

21. The major share of credit for a substantially successful Second Five Year Plan would almost certainly go to Nehru and the Congress Party. This would not only redound to their political advantage in the next general elections (which are due by the spring of 1962 — about a year after the end of the Plan period) but, more importantly, would support the present democratically inclined leadership in India's struggle for unity, stability, and economic betterment. Even when Nehru — and perhaps even the Congress Party as it now exists — disappear from the scene, the prospects for continuation of an effective parliamentary system under moderate leadership would have been strengthened.

22. Even if the government obtains only a part of the aid needed to close the remaining foreign exchange gap, it will be able to complete a sufficient number of large-scale proj-

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ects with significant psychological impact on the public (e.g., steel mills and dams) to be able to claim credit for major achievements. However, this favorable effect would be counterbalanced by popular restiveness over the austerity measures imposed to maintain the development program in operation and by widespread recognition that even these sacrifices were not producing the benefits initially hoped for. Reduction of social welfare programs and postponement of specific development projects would adversely affect local political attitudes.

23. Even assuming substantial success of the development program, India's ability to carry on as a united and democratic nation cannot be taken for granted. The future of the Congress Party, and more broadly of the democratic system in India, will probably be determined in the longer run as much by political and social as by economic factors. Divisive forces of caste, language, and regionalism will continue to pose a threat to the unity of India, although marked economic progress would contribute significantly to keeping them in check. The Congress Party, presently one of the country's major unifying factors, is tending to become estranged from the mass of the people because of its poor performance and leadership in the lower levels, its toleration of corruption and nepotism, increasing factionalism, and the lack of discipline of its local leaders. Dominance of the party leadership by Nehru and the "old guard" has prevented the emergence of vigorous new leaders. No effective steps have yet been taken to remedy these deficiencies nor are any likely to be taken so long as Nehru and other top party leaders remain preoccupied with their governmental roles.

24. The Congress Party nevertheless continues to possess important, although declining, elements of strength: Nehru's great personal prestige, a functioning organization throughout the country, and a reservoir of respect and loyalty (especially among the peasants) for its role in winning Indian independence. Perhaps most important of all, there appears to be little likelihood that the present fragmented and indecisive non-Com-

munist opposition will be able for some time to present a more serious challenge to the ruling party than it has in the past. Thus, on balance, it appears likely that the ideas, methods, and many of the leaders now represented by the Congress, will continue for a considerable time to exercise an important influence on the Indian political scene.

25. On the other hand, while the danger of a collapse of the Second Five Year Plan has been reduced substantially by the recent pledges of new aid, any further major reduction in Plan targets and achievements would weaken the faith of the Indian people that the kind of society and leadership represented by Nehru and the Congress Party was capable of coping with India's problems. The Communists and other extremists would probably make significant additional gains. The Congress Party could probably stay in power at the national level for some time because of its control of the machinery of government and the lack of an organized national opposition, but political stability would probably deteriorate fairly rapidly as the people responded to the more radical proposals of extremist groups.

26. *The Communist Party.* The Communist Party would probably benefit most from a decline in Congress Party strength. It is better organized than any other opposition party, and its members are more disciplined. It has attained a degree of respectability in recent years through its espousal of a policy of constitutional activity, whose showpiece is the Communist-governed state of Kerala. It has recently made significant gains in local elections in other states. It alone offers a clearcut alternative to the "old" or Congress way of doing things. Even if the Plan is successful, the Communist Party will probably attract increasing popular support in areas, such as West Bengal, where poverty and unemployment will remain acute. The Communists would be able also to make political capital out of the cancellation or postponement of Plan projects in given areas. In any case, the Communists will find fertile ground for their propaganda for many years to come among



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the growing ranks of the "educated unemployed" and the urban, industrial working force.

27. At the same time, the Indian Communist Party has shown little success in ridding itself of its traditional factionalism and still suffers from the stigma of foreign control. It has limited appeal in many areas of the country. If it were to lose control of Kerala state after failing to provide good government and economic improvement, its chances of extending its influence elsewhere would probably be reduced. On balance, we believe it unlikely that the Communists will be a serious threat to Congress Party control of the national government in the 1962 elections. Their strength will probably increase, however, and they will almost certainly continue for some years to be the major challenger to the Congress Party.

## VI. THE OUTLOOK FOR FOREIGN POLICY

28. India has during the past ten years so thoroughly committed itself to a policy of neutralism that any significant change in foreign policy appears most unlikely during the next few years regardless of the outcome of the development program. In recent months, however, Indian suspicions of the Bloc have been reinforced by the execution of the leaders of the Hungarian revolution and by harassment of Tito. At the same time, Nehru privately, if not publicly, appears to have become somewhat more sympathetic to the US on some issues.

29. India's appeal to the West for aid last year — the first such approach made by India — and again this year reflects not only India's belief that the best chance of obtaining the substantial aid which it needs lies in the West, but also its preference for obtaining such aid from the West, if possible. If Indians are convinced that the US has exerted itself to make a major contribution to their development program, some additional good will would almost certainly be created, although increased political cooperativeness as a direct result of expanded aid is highly unlikely. Most politically conscious Indians see the US as an enormously wealthy and prosperous country which has a duty to assist the underdeveloped areas of the world. Issues such as US military assistance to Pakistan, sponsorship of military pacts, and policies toward Communist China will continue to be more decisive than foreign aid in setting the tone of Indo-US political relations.

30. If India is subsequently forced to make further cutbacks in its development program as a result of failure to obtain the necessary aid from the West, some resentment against the West would almost certainly ensue and there would be increased attention to the Soviet Bloc as a source of economic assistance. If the Bloc also fails to supply the needed aid, the ensuing political and economic instability would strengthen the disruptive forces within the country. In such a situation India would become increasingly vulnerable to extremist, and especially Communist, influences.

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